IN THE

Supreme Court of the United States

October Term, 1944.

No. 28.

Claridge Apartments Company, a corporation,
Petitioner,

v.

Commissioner of Internal Revenue, *Respondent*.

REPLY BRIEF FOR PETITIONER.

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May it Please the Court:

On page 15 of his brief, respondent states:

> "No. 28' involves the meaning and application of sections 268 and 270 of the Bankruptcy Act to undisputed facts. Such questions are clearly questions of statutory construction; nor can they be said to be peculiarly within the experience of the Tax Court. We do not understand that the opinion in the *Dobson* case forecloses the circuit courts of appeal from reviewing decisions on such questions."

We do not contend that the "Dobson case forecloses the circuit courts of appeal from reviewing decisions on such

questions." Nor do we question that the statute confers on those courts the power to consider "the proper interpretation and application of the statute." We do not request any "narrowing of appellate jurisdiction". Nor do we question that a decision based on a plainly erroneous construction of a statute should be reversed.

We merely say, in the words of this court, as quoted on page 15 of our main brief:

> "But where the question is one of specific application of a broad statutory term in a proceeding in which the agency administering the statute must determine it initially, the reviewing court's function is limited. Like the commissioner's determination under the Longshoremen's & Harbor Workers' Act, that a man is not a 'member of a crew' (*South Chicago Coal & Dock Co.* v. *Bassett*, 309 U. S. 251, 84 L. ed. 732, 60 S. Ct. 544) or that he was injured 'in the course of employment' (*Parker* v. *Motor Boat Sales*, 314 U. S. 244, 86 L. ed. 184, 62 S. Ct. 221) and the Federal Communications Commission's determination that one company is under the 'control' of another (*Rochester Teleph. Corp.* v. *United States*, 307 U. S. 125, 83 L. ed. 1147, 59 S. Ct. 754), the Board's determination that specific persons are 'employees' under this Act is to be accepted if it has 'warrant in the record' and a reasonable basis in law."

Whether, on undisputed facts, debt is "canceled or reduced" is not one whit different than whether, on undisputed facts, one corporation is under the "control" of another or whether one person is an "employee" of another or was a "member of a crew" or was injured in "the course of the employment" or was "a producer of coal".

We call this court's attention to the argument of the government at pages 46 to 52 of its brief in *National Labor Relations Board* v. *Hearst Publications*, 322 U. S. 111, which is the same argument we make here and which the court adopted in that case.

In the *Dobson* case this court said:

> "However, all that we have said of the finality of administrative determination in other fields is applicable to determinations of the Tax Court."

Also the Tax Court is especially competent to decide whether debt was canceled, especially in view of the relation of the question to the income and basis provisions of the Revenue Act and its knowledge of reasons sections 268 and 270 were enacted and of the background of the situation which brought them into existence.

It should be noted that in the case at bar there is no conflict on this question between determinations of administrative agencies, i.e. the Commissioner and the Tax Court, because, as pointed out on page 4 of our main brief, the Commissioner did not determine the deficiency by applying Section 270 to this case and did not decide that it was applicable. Moreover, even in cases where there is such conflict, the practical background of tax administration, in the absence of a regulation (see *Biddle* v. *Commissioner*, 302 U. S. at p. 582) entitles the Commissioner's determination to very little, if any, weight for with the decentralization now in effect in the revenue service, the determinations of "the Commissioner" are not made by him or even by his Washington office but by hundreds of Revenue Agents scattered throughout the country. (See 56 Harvard Law Review, page 1001). They issue the notices of deficiency.

While the personnel of the Tax Court and our great Commissions is of the first quality and entitled to great respect, no one who has ever had any practical experience with these Revenue Agents would attach any great weight to their conclusions. A *prima facie* presumption in their favor, which gives way when evidence is introduced to the contrary, is all the weight that can be afforded them.

We quote the words of the government's brief in this court in the case of *National Labor Relations Board* v.

Hearst Publications, 322 U. S. 111, at pages 49 and 50, in support of our argument the Tax Court's decision cannot be reversed unless its application and construction of the statute is not a rational one.

> "This does not mean that the conclusions of an administrative body are final either on a 'fact' or a 'law' question. The determination of the administrative body must have 'warrant in the record' (*Rochester Telephone Corp.* v. *United States*, 307 U. S. 125, 146) and a reasonable basis in the law. Just as an administrative decision which is unsupported by substantial evidence has no rational basis in fact, so, too, an administrative ruling which is plainly unreasonable in the light of express statutory language or other convincing evidence of legislative intention has no foundation in law. For either vice administrative action may be set aside. But 'the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body.' *Rochester Telephone Corp.* v. *United States*, 307 U. S. 125, 146.
>
> "We believe that the scope of review which the court held applicable in *Gray* v. *Powell* to the administrative determination that the railway was a 'producer' under the Bituminous Coal Act of 1937 is a proper one here. With respect to that determination the Court said that 'the function of review placed upon the courts * * * is fully performed when they determine that there has been a fair hearing, with notice and an opportunity to present the circumstances and arguments to the decisive body, and an application of the statute in a just and reasonable manner' (314 U. S. at 411). If there has been a 'sensible exercise of judgment,' the administrative decision must be left undisturbed. (*Id.*, at 413.)"

On page 21 of our main brief it is stated the capacity of the Tax Court is about 1158 decisions a year. This is error. This was the number of cases heard last year, not decided. The Secretary of The Tax Court advises there were 662 opinions in cases heard for the fiscal year ended June 30, 1944. Of these cases, 445 were appealed. He also advises

that he has a record of appeals decided by the Circuit Court of Appeals, which shows that for the fiscal year ended June 30, 1944, 148 cases were affirmed, 73 were reversed and 16 modified. In other words, over two-thirds of the cases decided were appealed and, of those appealed, the Tax Court's decision was upset, in whole or in part, in about 40% thereof. This court cannot close its eyes to this condition and its effects on the business of the nation, on the revenue, on the general judicial administration of justice and where it will end, if it continues accelerated by the avalanche of tax-cases, high war rates and unequalled prosperity will spawn. (U. S. Law Week, at page 3418, states this court rendered 138 majority opinions at the last term.) There is a decided limit to the capacity of the courts to decide cases.

Also, consider how long; even at present, a case drags on. The petition was filed April 11, 1941 (R. 3). The case was not reached for trial until February 25, 1942 (R. 1). It was not decided until December 4, 1942 (R. 2). A year later the Court of Appeals decided it (R. 228). Look at the records here in other cases.

Under the present attitude of Courts of Appeal, the Tax Court, in two-thirds of its decisions, is a mere fact finding agency to certify facts to the Circuit Courts of Appeal for determination of the law. Only this court can call a halt to this and, it is submitted, the case at bar calls for doing it.

REPLY TO ARGUMENT ON THE MERITS.

As to the comment at the bottom of page 23 of the government's brief, the bankruptcy reorganization was "a mere change in the form of ownership", so far as the bondholders were concerned. It was not final so far as the outcome of their investment was concerned.

As to the comment about "a double deduction" on page 24, there was none here because it is admitted a nontaxable reorganization took place.

Also no income arose to the bondholders who for $277,000.00 bonds took over assets worth $141,000. On page 43 of his brief respondent concedes they sustained a loss. They could not deduct if because of the reorganization provisions. The stockholders equity to which they succeeded was worth below zero. The new corporation had no income because the assets were the subscription price of its stock. For the regulation which so provides and decision in accord therewith see Capento Securities Co., 47 B. T. A. at p. 695. Regulation also quoted in 140 F. (2d) at p. 386, affirming that case. Cf. *Helvering v. Cement Investors*, 316 U. S. 527. The old corporation also realized no income unless a mortgagee realizes income when the mortgagor forecloses and takes his home. Even on the theory that an insolvent debtor realizes income if it becomes solvent by the transaction (see Capento Securities case 140 F (2d) 382, Note 1) there was no income here because the insolvent lost all its property and did not have anything left to discharge its interest obligation. (In the American Dental case this court declared this distinction was without substance.) At the hearings on the sections 268 and 270 treasury counsel Kent told the Senate Judiciary Committee: "If the performance of the agreement involves the liquidation of all his assets, so that he has nothing left when the agreement is performed there is no tax question involved." He said it was otherwise if the debtor was left with free assets. (See p. 138, Senate Hearings on H. R. 8046, 75th Cong., 2nd session.)

On page 29 of his brief, respondent attempts to brush aside the Capento case but he cannot brush aside its reasoning which clearly demonstrates there was no income under the Kirby case in the case at bar. We ask the court to read both the Tax Court's and Appeal's court opinions in the Capento case. Also the legislative history shows sections 268 and 270 were addressed to situations within the supposed scope of the Kirby case and the Tax Court's opinion in the case at bar so states. The situation at bar produced no income under the Kirby case and hence there

was no need for legislation addressed to such situations.

The respondent's letter, contained at page 59 of our main brief, and written within five weeks of the enactment of sections 268 and 270 shows he held no debt was "canceled" in cases such as that at bar. If the Treasury opinion was this Congress probably would and did think the same. This letter was written after the hearings on sections 268 and 270.

We do not agree with the statement on page 24 that the continuation of the basis provisions in bankruptcy would be outside the scope of the purpose of the reorganization provisions. They cut both ways and were intended to prevent basis being stepped down as well as up. Furthermore, Congress, to guard against future effects of a decision in the government's favor in this case, expressly provided in the 1943 Act that the old basis carry over in bankruptcy after 1942. (See government's response to petition for certiorari, herein.)

As to the argument on pages 26 and 27 (also pages 37 to 39) that Congress rejected in 1940 an amendment to provide the basis should be reduced by the amount of income freed from tax by section 268 and this shows the 1938 law was not to be so construed we submit that the hearings show nearly all thought this was the intent and purpose of the existing statute and Congress would have so clarified it but many complained such an amendment would not save them because, in some cases, so many millions of debt was reduced that, if such reduction was income excluded from tax by section 268,[1] they would have a zero basis unless

[1] Testimony of Adams, Hearings on H. R. 9864, 52 to 55, at p. 54 (See also testimony of Edmund Burke, pgs. 13, 14. See also pages 18 to 20.)

> "The Congressman's suggestion is that 270 have added to it words to this effect: That the basis shall be reduced to the extent that the corporation is exempted from taxation under sec. 268. The difficulty, I understand, in that type of amendment is that no one knows to what extent the corporation is exempted under sec. 268 and it becomes very difficult to determine."

Congress provided the reduction should not go beyond the fair market value of the property. Congress, apparently, assumed the construction of existing law was as we contend but adopted the 1940 amendment to take care of such cases and afford them this needed relief.

The letter of Chairman Frank, of the Securities and Exchange Commission, contained in the House hearings at page 14, shows the uncertainty created by the *Kirby* case had brought reorganizations to a standstill and recites the millions by which debt was reduced therein. See list of reductions up to March 17, 1940 at pages 26, 29 and 30 of House hearings.

The sole purpose of section 270 is crystal clear. The Committee report, quoted on page 33 of our main brief, states it in these words:

> "This provision is intended to prevent a double deduction."

In the case at bar, there was no possibility of a double deduction. Although respondent, at page 34 of his brief, is not prepared to concede no income arises out of a bankruptcy readjustment, yet he cannot and does not deny that, if any income did arise when the plan was approved in 1935 or when the final decree was entered in 1937, such income was freed from tax by other provisions of law (See page 34 of our main brief) and not by section 268, enacted in 1938. Hence, it cannot be denied this case is not within the sole purpose and intent of section 270. The Tax Court pointed out it was to free corporations from the *Kirby* cases. Also no income arose here.

Under respondent's construction of section 270, it logically follows that where debt is paid, even in cash, it is thereby canceled but, in note 18 on page 27, he admits he takes "no such extreme position". Yet, it logically follows from his construction of the statute. See 41 Col. Law Review p. 73. Hence he admits the statute cannot be read literally.

On page 28 he states:

> "The legal effect of the transaction, both under corporate law and under tax law, was that the indebtedness on the bonds was paid to the extent of the value of the stock, and the remainder of the debt—the difference between the value of the stock and the principal amount of the bonds—was canceled. To the extent of this difference the transaction constituted a plain case of reduction of indebtedness."

It is inescapable that, if any debt was paid, the debt was all paid by the stock issue and it seems to us also inescapable that, if any debt was "canceled", it was all "canceled". Also, it surely was not merely reduced because none of it was left. Furthermore, under the decision quoted from at the bottom of page 42 of our main brief and many more, the debt was not paid under tax law.

In the strict sense, we do not think it was paid in any view because no one can pay himself, and the creditors, who were the equitable owners of the property, merely changed their evidence of ownership. The reason they could deduct no loss was because the tax law regarded the transaction as not finally closed.

The attempt, at page 40 *et seq.*, to answer our argument Congress, in a tax law, would have no reason to discriminate against federal bankrupts in favor of state court insolvent reorganizations, falls of its own weight. First, it asserts Congress may not have known what it was doing (that cannot be said of this court in deciding the instant case) and, at pages 42 and 43, that it was reasonable for Congress to penalize bankrupts for the benefits of bankruptcy. That Congress had no such intention is indicated by the provision in the 1943 Revenue Act that bankrupts shall have the transferor's basis, which was inserted to relieve, for the future, against a possible adverse decision in this case, albeit Senator Barclay stated in his speech on the veto it might not be needed. Also the provisions of sections 268 and 270 were unquestionably intended as relief provisions.

In answer to the argument on page 43, we pointed out on page 34 of our main brief that the bondholders were not allowed to deduct any loss on this transaction and the hardship of the construction sought and its conversion of income tax to a capital levy is discussed at page 43 of our main brief and explained by example.

On page 49 respondent says the words "for future tax purposes" in the Committee report relate to the event. By this reasoning, if Congress provided "stock dividends shall be taxable for future tax purposes" it would relate to the event of the dividend and impose a retroactive tax. "Tax statutes look to the future and not to the past". *Colgate-Palmolive Peet Co. v. United States*, 320 U. S. 422, 424.

Nor can respondent take any comfort from the Committee report (quoted at page 33 of our main brief) because, according to its express language, there must have first been income from debt forgiveness and, second, it must have been exempt from tax by section 268. This fully supports our argument on this point.

At the bottom of page 50 and top of page 51 of his brief, respondent concedes there is some merit to our contention, raised in the petition for the writ and at pages 47 to 50 of our main brief, that the Chandler Act did not apply to proceedings under section 77B closed by final decree long before it was enacted and that "as a matter of statutory construction, it is a plausible argument." However, he questions our right to raise the contention in this court.

We concede that, if the Commissioner had determined section 270 was applicable to this case and we did not raise this point below, we could not do so here. However, as pointed out on page 4 of our main brief, the Commissioner did not determine that section 270 was applicable and taxpayer did not appeal to the Tax Court from any such determination.

It was an issue which necessitated factual evidence of the value of the property at the date of the order confirming the plan, which was different than the date on which value was determined in the notice of deficiency.

If the Commissioner had raised it by answer the burden of proof would have been on him under Tax Court rule 14. Certainly, he is in no better position because he only raised it orally at the hearing. On this issue he failed before the Tax Court. In these circumstances, taxpayer should be able to raise here, to sustain the Tax Court's decision, the point that these sections do not apply to proceedings closed when they were enacted. This is a pure issue of statutory construction and, when this court takes a case to decide a matter of general importance, it ought not to leave it open on the overoptimistic assumption that more light would be cast on it had it been discussed by the court below than is now cast thereon by the arguments in the present brief.

However if the court holds the debt was not "canceled" or that the case is not within the object and purpose of sections 268 and 270—"to prevent a double deduction"—then because the court below declared the questions of interest cancelation and cost of the property moot and did not decide them the case can be remanded for their decision. If this course is taken the question whether the Chandler Act applies to cases disposed of by final decree before its enactment need not be decided here since it will only apply to the interest. It can be considered below in event the court below affirms the Tax Court's conclusion on the interest.

CONCLUSION.

(1) The meaning of Section 270 became fixed at the date it was enacted, June 22, 1938. It is submitted no one then thought bonds were 'canceled or reduced' when stock was exchanged for them. The Senate Hearings were held in January and February, 1938. As pointed out the Treasury gave examples of debt cancelation and reduction, none of which embraced the case at bar. All were real examples of debt cancelation or reduction. (See Kent page 138 of hearings.)

Three months after these hearings the Commissioner specifically ruled debt was not canceled (see our main brief

pages 35, 36) when stock was exchanged for bonds. He did not change his mind until three years later. It is reasonable that what the Treasury thought after the 1938 hearings closed, Congress also thought.

(2) On page 35 of his brief respondent says:

> "In the first place there is no warrant in the language of Section 270 for construing it as operative only to the extent that Section 268 has afforded in the particular case a relief not otherwise available."

As pointed out on page 8 hereof, respondent has in effect, admtted in Note 18 on page 27 of his brief, its literal reading as he reads it, would produce absurd results. In such case this court will "follow the purpose rather than the literal words." Also it cannot in such case, be read apart from its legislative history. With crystal clarity this shows the sole reason it was proposed by the Treasury was to avoid a double deduction and the Committee report states this was the sole reason it was adopted. No other reason is stated or suggested by its legislative history. The Tax Court held sections 268 and 270 were in pari materia and should be construed together (R. 196) and so did the court below. (R. 235.) The retroactivity argument at pages 47 to 51 of respondent's brief proceeds wholly on this theory.

The legislative history shows the relationship. Section 268 was the father of Section 270. Without 268 Section 270 would never have existed. If section 268 does not benefit a case then Section 270 was not intended to harm it. These sections were remedial not punitive. Just relief and not unjust oppression was their sole object. They should be so construed by this Court.

(3) Also this case calls for a determination whether the Tax Court is a mere fact finding agency to certify facts to the Circuit Courts of Appeal for decision or whether it is more than that. Pages 4 and 5 hereof show that up to this court's decision in the Dobson case that is all it was in over two thirds of the cases decided by it. The judicial system's ability to give prompt and speedy justice will be impaired

and the Nation's business will suffer and be forced by uncertainty to postpone important business transactions if this condition is not sharply checked. This case illustrates how far this condition has extended. The Tax Court, well knowing the theory and purpose of the depreciation allowance, the history and purpose of the reorganization provisions, the reason for the enactment of sections 268 and 270 and their legislative history writes its opinion against this background of experience and knowledge, which opinion touches all these points, and holds debt has not been canceled under the facts of this case. The Government appeals and the Court of Appeals declares the Statute is plain and the sixteen judges of the Tax Court do not know "the ordinary or literal meaning" of words and for alleged failure to know "the ordinary and literal meaning" of the word "canceled" its decision must be reversed. (R. 233) In this opinion the Circuit Court discloses it does not know the basis of depreciation but thinks it is the present value of property (R. 233-236), it fails to reveal that it knows anything about the legislative history of sections 268 and 270 and declares Congress was trying to eliminate "make believe water values" (R. 233, 236), it apparently fails to think of the reorganizations provisions of the revenue act and finally it thinks the debtor made a profit out of the transaction or if it did not, that it is somehow saving it from tax by its construction of the statute, which thought it expresses in these classical words: "We are relieving an insolvent debtor from an income tax on a profit which it did not make when its debts were reduced." (R. 236.)

Surely Congress did not intend reversals to be made on such patently untenable grounds that the Judges of the Tax Court do not know the "ordinary and literal meaning" of common English words. If the knowledge of a nominee for that Court was so wanting, or even if it was doubtful if he knew the "ordinary and literal meaning" of English words in common use, he would be so plainly unfit the Senate would never confirm him. If administrative bodies are to be reversed on such obviously untenable grounds as that they do

not know the plain and ordinary meaning of a common English word; all respect for them will be lost, and an avalanche of appeals to overwhelm the courts encouraged.

All of which is respectfully submitted.

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